Institute of Trading and Portfolio Management

Professional Options Trading Masterclass Video Series

POTM

Video 7

Naked Short Put Strategy

1. Short Put (Naked)

Quick Explanation

Opposite position to Long Put (Naked). You are obligated to buy stock at a specified price before a specified time if the contract is In The Money. Also known as Selling Put Options. you are essentially agreeing to buy the underlying security at a fixed price at some point in the future. If the underlying security goes up in price, then you make a profit, but if it goes down in price, then the puts you have written could be exercised. Although the short put is simple because it involves one transaction, you are exposed to a lot of potential risk. The short put is often referred to as having unlimited loss potential, but this isn't strictly true as the maximum you can lose per option written is the price of the underlying security, and that can only happen if the price of the underlying security falls to zero. Despite this fact, the short put can be a useful strategy to profit from a short-term price rise in an underlying security.

- **Directional Bet**
- **Bullish Strategy**
- **Simple**
- **One Transaction**
- **Net Credit (Upfront Payment Received)**
- **Max Gain (Limited)**
- **Max Loss (Limited)**

When to Use the Strategy

The Short Put (Naked) is a bullish options trading strategy, so you would use it when you expect a security to go up in value. You can only make a fixed amount of profit, it's best used when you are expecting a security to go up in value by just a small amount. You can actually also profit if the price of the security doesn't move at all. This is because the short put involves selling options contracts and you can therefore profit from the fact that time decay reduces the value of those contracts over time.

This strategy offers you no real protection against the underlying security falling significantly in value, so you should only use it if you are confident that the security isn't likely to decrease in price.

Additionally, if your intention is to OWN the underlying Stock, shorting a Naked Put that is OTM can be a really effective way to "enter" a new Long Stock position. You can decide exactly how much stock you would be willing to buy at a certain price below the current market price of the stock. For example, let's say your fundamental pre-disposition on a particular stock is Bullish however you believe that your timing might be off. You could Short (write) and Naked Put with a Strike Price that is say 5% Out of The Money (OTM) (below current market price of the Stock and receive a credit for doing so. If the stock falls to the strike price you are happy for the contract holder who is long the Put to exercise and sell you the Stock. So, you just added 5% value to your execution. If the Put expires Out of The Money i.e. Worthless then you keep the credit. If the stock is the same price as when you wrote / shorted the naked Put you just added the value of the credit to your execution and you can may now decide to buy the Stock using Capital you just obtained by writing the Put + the Capital you would have used previously to buy the Stock. Meaning it requires less of your previously side-lined Capital to purchase the Stock. Of course, the risk is that you write the Put and because your upside is limited to the premium you write you could miss the opportunity to own the Stock. If the Stock goes up higher than (current market price X the amount of Stock you intended to buy) i.e. by a value higher than the dollar value you received on your Credit then you have negative value to your execution capability.

"Selling a Put" is not strictly the same as Shorting a (Naked) Put because you can hold other positions that offset the change in value of the Put Option. For example, selling a Put could provide a short term Hedge to a Short Stock Position. If you are holding a Short Stock Position and you think that there might be a risk of a short-term squeeze higher in the Stock you could Sell an At The Money or Out of The Money Put and collect some premium i.e. take some profits off the table. If the Stock falls through the Strike Price before Expiry you will have to cover some or all of your Short. If the Stock Squeezes higher at least you collected some premium to offset any losses you may incur on your Short Stock Position. This however is not as effective as a Hedge against a Short Stock Position as buying a Call Option that is Out of The Money as the upside of shorting a Put is Limited to the Premium you collect. You would have to be very confident that the Strike Price of the Put you sell is going to be achieved and you will cover some or all of your short at the price, then the stock will rally afterwards. Otherwise you would be better off just either covering some or all of your Stock Short or buying an AT The Money or slightly Out of The Money Call. Remember the Long Call Option has unlimited Upside so if the Stock you are Short goes on a huge rally for no particular reason or for good reason your profits on the Call are unlimited and your losses on your Short Stock Position are unlimited. So being Long a Call is a much better hedge to a Short Stock Position.

How to Use the Strategy

How you use the Short Put (Naked) Strategy depends very much on your intentions. If you are just Bullish on a Stock and want to own it then due to its limited upside i.e. the credit you receive, then it doesn't make much sense to short Naked Puts At The Money or In The Money. Just Buy the Stock. If you are Bullish on a Stock Fundamentally and you are either already Long the Stock and intend to add to your position at a certain price below market price or you intend to open a new position to go Long a Stock at a certain price and / or you want to Fundamentally buy a Stock but you are unsure that your short-term timing is right, then Shorting a Put can add value to your execution as a Trader. Otherwise the Short Put (Naked) strategy doesn't add much value.

Warning! The Graveyard of former Options Traders is littered with the bodies of Naked Short Put Sellers. Do Not Short Naked Puts just for the hell of doing it / to "receive an income" from Trading. Many Traders use Shorting Naked Puts as a strategy to "take income from the market." They Short Naked / Write Naked Puts that are either Out of The Money or way Out of The Money thinking that because there is only a very small chance that a stock will go down by say 10% in a Week or 20% in a month that Shorting Naked Puts is like "free Money" or "taking candy from a baby." Nothing in the Financial Markets is free and there is no difference here in Shorting Naked Puts that are Out of The Money in order to take the credit as "income." Inexperienced Retail Traders look at the historical data of Stocks and figure out that a 2 Standard Deviation Move (2STD) in a week is let's say 9%. So, they Short Naked Puts continuously in order to "Bank the Premium." The odds are in their favour, and they can get away with banking premium for a long time, however they always in the end blow up because they have no Fundamental understanding of the Stock(s) they are Shorting OTM Naked Puts on and in the end, they always get caught out and give up all their gains and more when the Stock falls much more than expected due to a Fundamental change. They end up having to buy the Put back at a massive loss or they get assigned a Stock that they don't even know anything about, at a price way above the new market price after the stock has tumbled massively through the Strike Price where they are Short Naked Puts. Additionally, Selling Puts (and Calls) Naked Requires a lot of Capital and the Return on Invested Capital and Return on Notional Exposure is extremely low. This is because when writing way OTM Puts, credits are small yet exposure is massive. Way OTM Puts and Calls are much lower priced than At or In The Money Puts and Calls.

This is why when Shorting a Naked Put it is better to actually have an intention to Buy the Stock when you Short the Put. This way you can add value to your execution and you can sleep at night. Additionally, it just simply is not good discipline as a Trader to have massive amounts of unnecessary exposure for very little gain. As Traders we want to be taking as little risk as possible for as much gain as possible.

We have included the Short Put (Naked) Strategy in the "Useful" PDF because it does have its uses in adding value to traders but only when you intend to Buy a Stock. As above it is not even really a good hedge for Short Stock Positions. Other than as an execution tool to get into Long positions at certain prices that you actually want, the Short Put (Naked) Strategy is pretty useless. We also included it here and in the POTM Video Series (with examples) as a cautionary tale as a deliberate message to Retail Traders NOT to do it for the sake of income / banking premium. Do not do it! You have been warned! .., if you ever come across an educator who tells you to do this as an "easy money strategy" you should be taking them to school, not the other way around!

Break Even

Break-even point is when **Price of Underlying Security = (Strike Price - Price of Option)**

Profit Calculations (Maximum Upside)

Profit is limited, per option written, to "Price of Option"

Maximum profit is limited and made when **"Price of Underlying Security > or = Strike Price**

Risk Calculations (Maximum Downside)

Maximum loss is limited only by how much the underlying security can fall.

Loss is incurred when **Price of Underlying Security < (Strike Price – Price Per Option)**

Loss per option written is **Strike Price – (Price of Underlying Security + Price Per Option)**

Strategy Example

Below you will find an example of this strategy using At The Money (ATM) Puts. The purpose of this example is purely to provide an overview of how the strategy works and it doesn't use precise prices. Commission costs haven't been included for the sake of simplicity.

Initial Trade

- Company X stock is trading at $50, and you expect it to increase slightly in price.
- At The Money (ATM) Puts of Company X stock (strike price $50) are trading at $2.
- You write 1 Put contract (1X Contract = 100 Shares) for a credit of $200.

If Company X stock increases to $51 (or higher) by expiration

The options will be out of the money at expiration, and therefore worthless. You'll have no further liability and the $200 credit you received when writing them will be your profit.

If Company X stock remains at $50 by expiration

If the Options are At The Money (ATM) at expiration, also making them worthless. The $200 credit is your profit.

If Company X stock falls to $48 by expiration

The Options will be In The Money; therefore, you will have a liability. In this case, you will have around $2 per option for a total of $200. Taking into account your upfront credit of $200, you will have roughly broken even.

If Company X stock fell below $48 by expiration

You would start to lose money. You should be aware, though, that at any point prior to expiration you can buy the contracts back. This will incur a loss if the stock has fallen in value, but it will prevent further losses from a continued fall.